

Operational Risk Assessments News Bulletin

KeyBank Real Estate Capital

Morningstar Assigns KeyBank 'MOR CS1/Stable' Rankings as a Small Balance Commercial Mortgage Primary and Special Servicer

Morningstar Credit Ratings, LLC (Morningstar) has assigned KeyBank Real Estate Capital (KBREC) 'MOR CS1' rankings as a small balance commercial mortgage primary and special servicer. The forecast for both rankings is Stable. The assigned rankings reflect our assessment of KBREC's operational infrastructure and portfolio administration capabilities for its respective duties as a primary and special servicer of small balance commercial mortgage loans and REO properties. (Additionally, please refer to Morningstar's May 2012 companion servicer assessment report on KBREC, which covers KBREC's rankings as a primary, master, and special servicer for large CMBS and other large loans).

For classification purposes, Morningstar defines small balance commercial mortgage assets as those loans and REO properties having unpaid principal balances (UPB) of \$3 million or less. Our assessment takes into account that small balance servicers' and special servicers' portfolios may include some larger assets. However, our expectation is that their average asset sizes are generally well below our \$3 million threshold and that their small balance portfolios will typically be concentrated with assets in the \$500,000 to \$1.5 million range.

Unlike some residential mortgage servicers that have expanded their operations into small balance commercial mortgage loans, which can often have certain servicing characteristics indicative of residential loans, KBREC operates solely within a commercial real estate, credit, and servicing environment. Additionally, in our view, KBREC's small balance portfolio has a higher average loan size in relative terms compared to the portfolios held by some of these other servicers and overall may have more characteristics akin to true commercial mortgage loans. We believe that KBREC has effectively leveraged and customized its operational infrastructure and existing practices to serve as a proactive and diligent commercial mortgage servicer and special servicer for small balance commercial mortgage loans, which we consider to be a niche business.

On March 30, 2012, KBREC entered into a subservicing agreement involving the transfer of approximately \$40 billion (about 4,500 loans) of its entire CMBS primary servicing portfolio to Berkadia Commercial Mortgage in exchange for obtaining FHA deposit accounts. KeyBank remains the named master, primary, and special servicer, respectively, on these CMBS. While this exchange will significantly shrink KBREC's primary servicing portfolio and cause a corresponding staff reduction, we do not believe the transaction will adversely affect or diminish KBREC's servicing capacity or capabilities and, therefore, view it as a ranking-neutral event based on KBREC's planned organizational changes. However, we are monitoring KBREC's organizational structure and overall performance relative to this announcement.

Our assessment and assigned small balance rankings are based on the following composite factors:

- Our positive opinion of KBREC's servicing capabilities and expertise to meet its third party reporting and compliance requirements. The company did not incur any material reporting errors or restatements during 2011.
- KBREC's excellent technology tools, sound data security and disaster preparedness protocols, high level of automation, and centralized data management to accommodate a diverse and large servicing portfolio while also yielding a high degree of operating efficiency. In particular, we believe the company's proprietary asset management and reporting application called RECWeb is highly effective for workflow management and managing specially serviced assets, with many customized features to address both internal and investor reporting requirements.
- KBREC's overall operational stability and solid levels of industry experience among management and professional staff. While KBREC incurred higher staff turnover during 2011, much of it was attributable to intra-bank transfers related to career advancement. However, the respective average years of industry experience for its portfolio management staff, and especially its special servicing asset managers, while solid, is lower than the average among servicers and special servicers primarily handling larger balance assets. The average for special servicing asset managers also may have been diluted since 2010 as the company hired for its smaller balance assets. KBREC does not outsource servicing functions and it centralizes nearly all servicing and special servicing operations in one location.
- KBREC's independent internal audit function that annually examines a range of loan administration and portfolio management processes, and is supplemented with a number of performance monitoring and compliance routines embedded in the company's workflow practices.

- KBREC's effective practices and procedures for proactive small balance asset-level management and portfolio oversight, which include a number of reporting tools managed through a robust proprietary technology application, to monitor collateral performance, track compliance and trigger events, and respond to borrower requests.
- KBREC's very high annual property operating statement collection rates and a policy of pursuing annual property inspections within its small balance portfolio. We view this level of achievement as being very atypical for small balance assets.
- Our belief that KBREC is a very proactive and effective special servicer for smaller balance loans with a diligent and pragmatic approach, sound analytics, and a corresponding successful resolution record especially during the past two years. Although KBREC has successfully resolved some larger, very complex CMBS loans, we view small balance special servicing as a particular strength.
- We believe that the FDIC's awarding to KBREC one of only two servicer asset resolution flow contracts in late 2010 is a further testament to KBREC's special servicing capabilities particularly with respect to smaller balance loans.
- Our belief that KBREC has effective policies and procedures to manage conflicts of interest. Overall, we generally view KBREC as a special servicer that operates without the potential conflicts of interest inherent in transactions in which the special servicer has a close affiliation with the CMBS B-piece investor. KBREC's business model is to act as an independent, third party special servicer without any investment in subordinate CMBS. In addition, KBREC does not have or use affiliates to purchase or sell assets within securitization trusts.

As of December 31, 2011, KBREC's total small balance servicing portfolio, excluding loans sub-serviced by others, was approximately \$6.6 billion by UPB (7% of its total serviced portfolio) and 6,182 by loan count (57% of its total serviced portfolio). The company experienced an increase in overall portfolio volume by loan count during 2011, which largely reflected 12 new assignments as a CMBS primary servicer and 4 new assignments as a CMBS master servicer, and the FDIC's award to KBREC of a multi-year servicing and asset management pre-securitization flow contract in late 2010. Within the 16 new CMBS servicing assignments obtained in 2011, small balance loans accounted for 3% of the total by UPB and nearly 46% of the total by loan count.

As of December 31, 2011, KBREC was the named special servicer on 28 CMBS transactions (\$14.1 billion by UPB consisting of 2,372 loans). During 2011, KBREC was appointed as the special servicer on four new CMBS transactions consisting of 421 loans (total UPB of \$3.7 billion). As of December 31, 2011, its total active small balance special servicing portfolio of loans and REO was approximately \$69 million by UPB and 88 by asset count (\$784,000 average asset size), excluding small balance assets contained in the FDIC portfolio.

Forecast

Stable for both rankings. We believe KBREC will continue to serve as a highly effective servicer and special servicer of smaller balance commercial mortgage loans and REO properties. We expect our assigned rankings to remain unchanged during the next 12 months.

Our full assessment report on KBREC as a small balance servicer and special servicer is forthcoming and will be made available on our website.

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